Office of Chief Counsel
Internal Revenue Service

memorandum

CC:WR:RMD:DEN:TL-N-2298-00
AMHarbutte

date: **AUG 23 2000**

to: Gene Bybee, Revenue Agent, Salt Lake City

from: Alice M. Harbutte, Attorney, Denver, Colorado

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subject: [redacted]'s Pre-Filing Submission
Pre-Filing Pilot Program

The purpose of this memorandum is to provide you with supplemental advice concerning the brokerage fee paid to [redacted] by [redacted]'s in connection with the acquisition of [redacted]. Our initial advice is set forth in our memorandum dated August 15, 2000.

BACKGROUND

In our earlier memorandum dated August 15, 2000, we concluded that the $[redacted] brokerage fee paid by [redacted]'s to [redacted] was not a deductible expense under I.R.C. section 162 and was not amortizable as an investigatory cost under I.R.C. § 195. One basis for this conclusion concerned the fact that [redacted]'s presented a coy of the engagement letter setting forth the terms under which [redacted] was hired. This letter is dated [redacted], which date is after the decision was made by the [redacted]'s Board of Directors to commence formal acquisition negotiations with [redacted]. In addition, the letter sets forth the tasks to be performed by [redacted]. All tasks called for by this letter relate to work to be performed by [redacted] concerning the acquisiton of [redacted] by [redacted]'s. Nowhere in this letter is [redacted] instructed, required or authorized to perform any analysis to assist the taxpayer in determining which entity to acquire. A copy of this letter is attached as **Exhibit A.**

ADDITIONAL FACTS

On [redacted], the taxpayer presented additional facts and requested that the Service consider these additional facts prior to reaching a conclusion concerning the correct tax treatment of the [redacted] fees. The taxpayer stated that [redacted] was called by a senior management official from [redacted]'s in early [redacted] and was requested to perform studies and analyses for [redacted]'s with respect to various transactions in order to assist [redacted]'s in determining which company to acquire. [redacted]'s represented that no written fee agreement was entered into with [redacted] at this time. [redacted]'s has represented that [redacted] spent approximately [redacted]% of its time "investigating possible combinations with different targets;" [redacted]% of its time on "ongoing client matter;" and [redacted]% of its time performing "investigatory and due diligence related services rendered to help [redacted]'s evaluate a merger with [redacted] prior to receiving FTC approval." [redacted]'s apparently agrees that the remaining [redacted]% of the $[redacted] should be capitalized.

The first two items, totaling [redacted]% of [redacted]'s time, are not discussed in the engagement letter. With respect to the category covering [redacted]% of [redacted]'s time, [redacted]'s takes the position that all of this work was performed prior to the date the merger was approved by the board in [redacted]. [redacted]'s takes the position that the law covering the issue of the proper "decision date" is unclear and that since FTC approval was not received until [redacted], the time frame from the date negotiations commenced up to the final approval of the FTC is all pre-decisional and these costs therefore qualify as investigatory costs and are deductible under I.R.C. § 162[1]. All the percentages set forth in the [redacted] letter are based upon interviews of [redacted] employees performed by the accounting firm of [redacted]. Copies of the cover sheets for the various presentations [redacted] made to the [redacted]'s Board of Directors together with the [redacted] letter are attached and marked as **Exhibit B**.

[redacted]'s has represented to the Service that due to the way the brokerage industry works, this type of fee arrangement that they had with [redacted] is common. [redacted]'s stated

[1] Our position concerning this issue has not changed. Rev. Rul. 99-23 clearly states the Service's position, that the decision date is the date the taxpayer focuses on a specific company and not the date a merger is finally approved. Applying Rev. Rul. 99-23 to the facts of this case the decision date is July 28, 1998. See, Ellis Banking v. Commissioner, T.C. Memo. 1981-123, aff'd in part & rem'd in part, 688 F.2d 1376 (11th Cir. 1982).

that generally, a brokerage firm will work and perform due diligence without any formal fee arrangement, knowing that any fee ultimately paid will only occur if the merger is successful, thus, the high fees being paid to brokerage firms for successful transactions.

As a result, [redacted]'s argues that [redacted]% of the fees paid to [redacted] are deductible. This position is not supported by the facts. First, the brokerage fees paid to [redacted] are specifically made contingent upon the merger going through. Second, the fee arrangement set forth in the engagement letter was formally entered into after the date on which negotiation with [redacted] commenced and does not provide for any investigatory type of work to be performed.

DISCUSSION

These additional facts do not change the conclusion reached in our earlier memorandum dated August 15, 2000, and it remains our opinion that the entire fee paid to [redacted] on [redacted], should be capitalized. Assuming the facts presented by [redacted]'s are true and that the taxpayer can establish through testimony of [redacted] employees the amount of time spent on investigatory tasks, this does not change the voluntary fee arrangement reached by these unrelated parties, as set forth in the engagement letter. [redacted] may have spent numerous hours performing tasks and may not have received any fee for this work if [redacted]'s had chosen not to hire them. Fortunately for [redacted], the risk they took paid off. They were hired, the acquisition was successful and they earned a large fee. Had the acquisition failed [redacted] would not have been owed any fee by [redacted]'s. The liability to pay [redacted] $[redacted] arose on [redacted], and by the specific terms of the engagement letter this payment was not for any of the investigatory type of work performed during [redacted].

The taxpayer argues that the Service should ignore the written agreement and look at the way the brokerage industry works. In general, federal income tax consequences are governed by the substance of a transaction determined in accordance with the intentions of the parties to the transaction, the underlying economics, and all other relevant facts and circumstances. There is an extensive body of case law relating to the determination of the substance of transactions. It is well established that the Commissioner may look through the form of a transaction to its substance. Gregory v. Helvering, 293 U.S. 465, 470 (1935). A taxpayer may also assert that a transaction should be taxed in accordance with its substance rather than its form. However, case law recognizes that taxpayers may be advantaged by having the power to structure transactions in the first instance and by having unique access to the facts that reflect the substance. The possibility exists for the parties to a transaction to inconsistently characterize the substance of the transaction by asserting slightly different critical facts upon which the substance hinges. By contrast, the government is at a potential disadvantage in ascertaining and evaluating the relevant facts of a transaction. In light of these considerations, courts have held that the circumstances under which a taxpayer may disavow the form of a transaction in favor of its substance are limited. See Commissioner v. National Alfalfa Dehydrating & Milling Co., 417 U.S. 134, 149 (1974).

Similarly, the Tax Court and several Circuit Courts have generally subjected taxpayers to a higher standard of proof before permitting them to contradict a written contractual provision when attempting to establish the substance of the transaction. In order to contradict a contractual provision, the courts require either "strong proof" that the substance of the transaction is other than is indicated by the contractual provision, or the more restrictive "proof which an action between the parties to the agreement would be admissible to alter that construction or to show its unenforceability because of mistake, undue influence, fraud, duress, ect." Compare Ullman v. Commissioner, 264 F.2d 305 (2d Cir. 1959) with Commissioner v. Danielson, 378 F.2d 771 (3d Cir. 1967) cert. denied, 389 U.S. 858 (1967).

In the present case, under either the Danielson restrictive rule or the "strong proof rule," the facts presented by the taxpayer do not establish that the written engagement letter should be ignored and the substance, as represented by the taxpayer, applied so as to permit a deduction. The taxpayer has not presented "strong proof" that the terms of the written contract, i.e. the engagement letter, should be ignored. Verbal statements and copies of slides used in presentations by [redacted] are not strong proof. Two unrelated parties, [redacted] and [redacted]'s, purposefully chose to structure the fee arrangement as set forth in the letter dated [redacted] [redacted]'s could have paid [redacted] under a different fee structure that would have obligated them to pay for investigatory types of work. [redacted]'s chose not to do this. The fact that this may be an "industry practice" does not change the form of payment chosen by the parties.

CONCLUSION

The fees paid to [redacted] are specifically related to the acquisition of [redacted] by [redacted]'s and must be capitalized under I.R.C. 263. No portion of the $[redacted] should be allowed as a deduction under I.R.C. 162. No portion of this fee is amortizable under I.R.C. 195.

If you have any questions relating to this memorandum please call Attorney Alice M. Harbutte at (303) 844-3258.

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